

**Reviews of financial terms for
Channel 3 and Channel 5 licences:
Background note**

Consultation

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Section 1

Background to the reviews

- 1.1 The financial terms of the Channel 3, Channel 5 and Public Teletext licences require the holders of the licences to make licence payments (“Additional Payments”) to the Treasury. The financial terms were originally set following competitive tender processes, in 1991 for the Channel 3 licences and the Public Teletext licence and in 1995 for the Channel 5 licence.
- 1.2 The financial terms consist of a percentage of qualifying revenue (PQR) and a cash sum payable for each year of the licence period. The current financial terms were set by the Independent Television Commission (ITC) at the time of the most recent renewals of the analogue broadcasting licences.
- 1.3 Section 225 of the Communications Act 2003 (the “Act”) allows for Channel 3, Channel 5 and Public Teletext licensees to apply for reviews of their financial terms for payments to the Treasury. Separately, the Act required Ofcom to offer to replace the existing analogue broadcasting licences with Digital Replacement Licences (DRLs) prior to 29 December 2004.
- 1.4 Ofcom published a consultation¹ on draft versions of the DRLs in September 2004 and offered the licences in November. Each licensee took up the option to accept the DRLs, which expire on 31 December 2014 as set out in section 224 of the Act.
- 1.5 Under the Act, the earliest date on which a licensee can apply for a review of its financial terms is four years prior to the expiry date of its analogue licence. Ofcom consulted in January 2004² on the process for undertaking reviews of the financial terms of the DRLs. In this consultation, Ofcom proposed to offer Channel 3 licensees the opportunity to align the expiry dates of their analogue licences and, therefore, the dates for reviews of the financial terms of the DRLs. Channel 3 licensees therefore had the option to apply for reviews from 31 December 2004.
- 1.6 In order to promote further consistency across all broadcasting licences, Ofcom subsequently proposed in July 2004 to extend the offer to bring forward the dates of their financial review periods to begin on 31 December 2004 to the Channel 5 and Public Teletext licensees.
- 1.7 In July 2004, Ofcom consulted³ on the methodology which Ofcom proposed to use for undertaking financial reviews of the Channel 3 licences. In October, Ofcom concluded that a broadly similar methodology should also be applied in the event that the Channel 5 or Public Teletext licensees applied for a review. On 13 October 2004, Ofcom set out the methodology to be adopted in its published Statement, “*Methodology for reviews of financial terms for Channel 3, Channel 5 and Public Teletext licences*” (“the October Statement.”)⁴
- 1.8 In January 2005, Ofcom announced that all Channel 3 licence holders (other than Channel Television) and Channel 5 Broadcasting Limited, the current holder of the Channel 5 licence had applied for a review. Teletext Limited did not apply for a

¹ http://www.ofcom.org.uk/consult/condocs/drl/drl_condoc/#content

² http://www.ofcom.org.uk/media/news/2004/01/nr1_20040126#content

³ http://www.ofcom.org.uk/consult/condocs/channel3_consultation/channel3_consultation/#content

⁴ http://www.ofcom.org.uk/media/news/2004/10/20041013_nr#content

review of its Public Teletext licence. Licensees who did not apply for a review of their financial terms may choose to do so at a later date.

- 1.9 Today, Ofcom has announced the outcome of its review of financial terms for those licensees which applied for a review. The purpose of this document is to provide some background information in relation to the process and various factors relevant to the reviews. This document does not aim to provide an account of the reasons for the determination, and it should be regarded as background information only.

Next steps for licensees

- 1.10 Applicants have four weeks within which they can elect to accept these revised terms which, if accepted, will be backdated to January 1st 2005.

Section 2

Ofcom's determination of financial terms

Percentage of qualifying revenue and cash sum

2.1 Ofcom has determined the PQR rates to be applied from January 1st 2005 to December 31st 2014, and has determined that the amount that, in its opinion, that would have been the cash bid of the licence holder were the licence being granted afresh on an application made in accordance with section 15 of the 1990 Act, as follows:

Table 1: Revised terms by licence

	PQR	Cash sum (£'000s)
Anglia	10%	180
Border	0%	10
Carlton	26%	1,120
Central	11%	900
GMTV	30%	230
Grampian	6%	60
Granada	9%	240
HTV	0%	10
LWT	21%	720
Meridian	14%	320
Scottish	0%	10
Tyne Tees	0%	10
UTV	5%	120
Westcountry	0%	10
Yorkshire	3%	240
Channel 5	8%	680

2.2 If accepted, these terms would replace the existing terms which currently apply. Those terms are provided in Table 2, below

Table 2: Existing terms (2004)

	PQR	Cash sum (£'000s) paid in 2004
Anglia	17%	3,631
Border	2%	79
Carlton	20%	17,849
Central	17%	7,994
GMTV	23%	4,523
Grampian	6%	111
Granada	15%	4,278
HTV	7%	2,323
LWT	17%	5,176
Meridian	23%	12,897
Scottish	11%	1,800
Tyne Tees	16%	2,239
UTV	5%	611
Westcountry	13%	1,289
Yorkshire	22%	8,524
Channel 5	8%	4,318

Calculation of Additional Payments

- 2.3 The cash sum is increased annually in line with the RPI.
- 2.4 For the Channel 3 and Channel 5 licensees, qualifying revenue consists mainly of advertising and sponsorship revenue.
- 2.5 The basis of calculation of the PQR payment is set out in more detail in *Statement of Principles and Administrative Arrangements under the Broadcasting Act 1990, the*

Broadcasting Act 1996 and the Communications Act 2003 (Fifth Edition), laid before Parliament on 16 December 2004⁵.

- 2.6 For the purposes of calculating the Additional Payments, Ofcom will apply the PQR to qualifying revenue that includes revenues from both the analogue services (“Analogue qualifying revenue”) and digital terrestrial services (“Digital terrestrial qualifying revenue”). However, for the reasons explained below, Ofcom will assign a weighting to each category.
- 2.7 The weighting that will attach to analogue qualifying revenue will be 100%. The weighting that will attach to digital terrestrial qualifying revenue will be zero. The weighted calculation will therefore result in the same total PQR payments as if PQR was only applied to analogue qualifying revenue.
- 2.8 Analogue qualifying revenue will be calculated by reference to the proportion of homes that do not receive digital services or analogue cable services. Digital terrestrial qualifying revenue will be calculated by reference to the proportion of homes that receive digital services via the digital terrestrial service and no other digital service. Where households receive digital services via the digital satellite or digital cable platforms, these households will not be included in the calculation for digital terrestrial qualifying revenue.
- 2.9 The reasons for apportioning total qualifying revenue into separate analogue and digital terrestrial categories, and for applying a weighting to each category, were explained in the July Consultation and October Statement. In brief, the purpose of the system of additional payments is to recover a fair share of the value of the Channel 3, Channel 5 and Public Teletext licences for the taxpayer. Ofcom considers that the correct definition of Qualifying Revenue in relation to these licences includes revenue derived from both the analogue and digital terrestrial platforms. However, it would be inconsistent with the principles of a fair and reasonable valuation to treat analogue and digital qualifying revenue identically for the purpose of collecting additional payments, as the value of the licence is different in the two cases. The analogue broadcasting rights are scarce, and obtainable only via these licences, while the digital terrestrial broadcasting rights can also be obtained in the market.

PQR/ cash split

- 2.10 Ofcom has to determine what PQR to set as well as to determine the cash bid. Ofcom therefore needs to decide much of the total value of the licence it should recover through each of the two elements of the payment.
- 2.11 In the past, the ITC aimed to recover approximately 75% of the value of each licence via the PQR payments and the remaining 25% via the annual fixed cash sum payments. In the October statement, Ofcom indicated that it would recover between 75% and 95% of the licence value through the PQR, with the remainder being recovered by the cash bid.
- 2.12 In making its determinations, Ofcom considered that the PQR should be calculated to recover as close to 95% of the value of the licence as possible, without exceeding this proportion whilst being consistent with setting the PQR as an integer. Therefore, while Ofcom has attempted to recover close to 95% of the value of the licence from the PQR, the PQRs for each licence will recover less than this proportion (although

⁵ Qualifying Revenue and Multiplex Revenue: Statement of Principles and Administrative Arrangements under the Broadcasting Act 1990, the Broadcasting Act 1996 and the Communications Act 2003 (Fifth Edition), laid before Parliament on 16 December 2004.

more than 75%). The level of the cash bid was then set to recover the balance of the value of the licence.

- 2.13 Ofcom considers that this higher weighting of the PQR element is appropriate for a number of reasons.
- 2.14 First, it provides the best mitigation available for taking into account future uncertainties in relation to, for example, advertising revenue.
- 2.15 Secondly, because the analogue PQR is applied only to revenues attributed to homes which do not have access to digital reception equipment, the recovery of a higher proportion of value through the PQR means that the extent of licence payments will decline more sharply as digital penetration of homes increases than would have been the case if a higher proportion of value had been recovered through the cash bid. Ofcom considers that the annual payments will therefore correlate more closely to the value of the rights conferred by the licences, as the principal right is access to the scarce analogue spectrum.
- 2.16 Finally, a lower cash bid maximises the scope for Public Service Broadcasting to be maintained during and after digital switchover.

Section 3

Context for the determinations

- 3.1 The current financial terms for the Channel 3 licences were set by the Independent Television Commission (ITC) during the last round of licence renewals. New terms resulting from those reviews became effective commencing on various dates between 1999 and 2001. The Channel 5 terms were revised effective from April 2003.
- 3.2 Since the last round of licence renewals, there have been many important developments in the broadcasting sector in terms of economic, regulatory and market conditions. As explained below, as a result of these changes, the value of the net benefits associated with the licences, and therefore the value to be recovered via the Additional Payments, is now significantly less than it was at the time of the last reviews.

Ofcom's objectives

- 3.3 Ofcom's principal objectives for these reviews of financial terms have been to determine a fair and reasonable value for each licence, and to set new financial terms according to a fair and objective process, in order to ensure that the taxpayer gets a proper return for these licences and, in particular, the right to use scarce analogue spectrum. With this in mind, the aim of the process has been to set terms that are reasonable within the context of the current market environment, and that so far as possible continue to be reasonable for the period of the licence. The terms announced today were determined with these objectives in mind.
- 3.4 Ofcom has also taken carefully into account a number of related developments in the broadcasting market and regulation, including:
- The increasing penetration of digital television, which reduces the scarcity value of the analogue spectrum.
 - The expectation that digital switchover will be completed by 2012, ceasing use of the analogue spectrum.
 - Ofcom's review of Public Service Broadcasting, and associated decisions on licensees' PSB obligations in February and June 2005.

Legal framework

- 3.5 Section 227 of the Communications Act sets out the statutory framework for the reviews. Ofcom must determine two items:
- a fixed annual cash amount to be paid for the licence, which is updated each year in line with the Retail Price Index;
 - a percentage of qualifying revenue to be payable for each year of the licence.
- 3.6 In respect of the fixed annual cash amount, the Act requires Ofcom to determine the amount that, in its opinion, "would have been the cash bid of the licence holder were the licence being granted afresh on an application made in accordance with" section 15 of the Broadcasting Act 1990.

- 3.7 Ofcom is therefore required by the statute to reproduce the effects of a hypothetical auction of the licences, and this requires making a judgement not just about the value of the licence to the incumbent but also to a new entrant. This is because the minimum amount the incumbent would need to bid in a competitive auction in order to win the licence would be the sum required to beat the next highest bid, which would be from a new entrant.
- 3.8 The valuation of the licence does not therefore represent an assessment of the value of the existing licensee's business. The existing operator's business may, for example, include other activities which are unrelated to the ownership of the DRL, such as production businesses or thematic channels on other platforms. These, and other, items fall outside the scope of the valuation of the DRL.
- 3.9 In order to determine the amount of the second-highest bid in an auction, Ofcom has sought to estimate the net present value of an efficiently operated licence. This assessment has been informed by (but is not necessarily the same as) the incumbent's current and forecast cashflows, adjusted to reflect any additional costs, such as start-up costs, for a new entrant.
- 3.10 Each licence has been valued as if it were being auctioned separately. Ofcom's view remains that an actual auction for the licences would be designed, within the framework of the statute, to recover the maximum possible value consistent with the licensee being able to fulfil all of the programming and other obligations associated with the licence. It would therefore offer as many of the licences as possible simultaneously and would allow contingent bids for multiple licences. However, as explained in the October Statement, for the purposes of conducting a hypothetical auction, Ofcom considered that the statutory framework makes it infeasible to assume that there is a multiple contingent bid auction. Ofcom has therefore valued each licence on the basis that the licences would be auctioned separately.

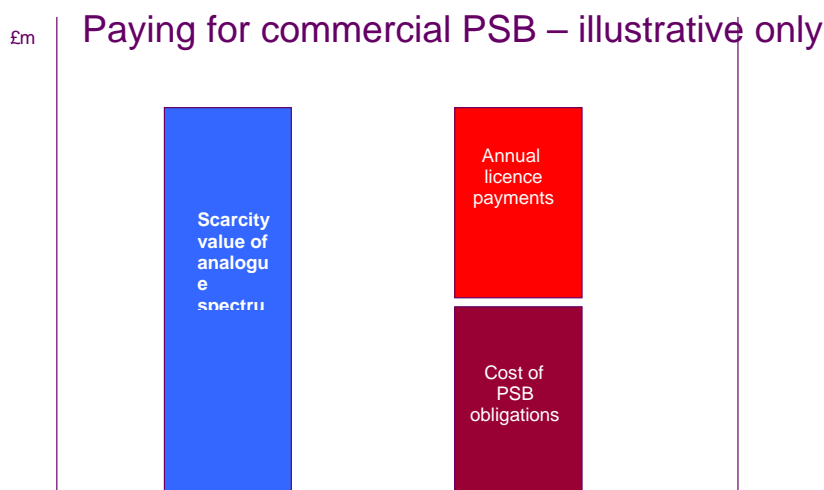
Scarcity value of analogue spectrum and the PSB compact

- 3.11 Historically, holders of the Channel 3, Channel 5 and Public Teletext licences have been prepared to pay additional payments and accept PSB obligations in return for access to scarce analogue spectrum for the purposes of broadcasting a commercial television service. In the past, analogue spectrum was a unique means of providing such services and would-be television broadcasters in the United Kingdom had no other route to market. Over time, through the development of cable, satellite and digital terrestrial television, other platforms have emerged which provide would-be broadcasters with routes to market that are not dependent upon access to analogue spectrum.
- 3.12 However, unlike the capacity to broadcast services on these new platforms, which can be purchased in the commercial market, availability of analogue spectrum is scarce and access strictly regulated. Although other routes to market are available for would be broadcasters, the analogue spectrum retains certain unique attributes which mean that access to it remains valuable. Analogue coverage is essentially universal and the number of homes without equipment providing analogue reception is very small. The same cannot be said for any of the other individual platforms which may be used as an alternative route to market.
- 3.13 A key benefit of holding a licence which gives access to analogue spectrum is therefore realised in terms of the audience reach available. The analogue signal remains the most watched mode of transmission and offers viewers the least choice. This means that commercial broadcasters with access to the analogue platform are

able to deliver larger mass market audiences to advertisers. This gives rise to a number of significant benefits for analogue broadcasters, both in terms of a unique proposition to offer advertisers and, potentially, in terms of improved economies of scale through, for example, programming economics.

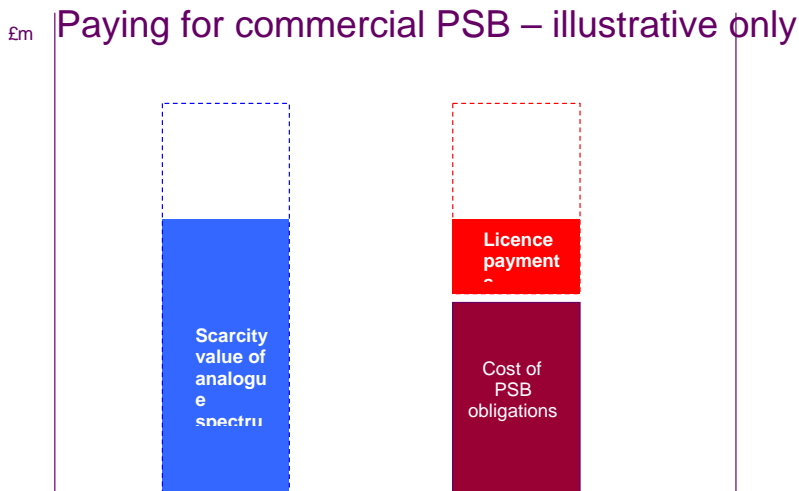
- 3.14 In return for this unique access, licence holders are prepared to undertake several obligations. In financial terms, the most substantial of these are a commitment to Public Service Broadcasting and the need to make additional payments. Together, these two elements have been referred to as the 'PSB Compact'.
- 3.15 It was noted in Ofcom's Public Service Broadcasting Review that the PSB Compact changes in the digital environment. The costs of PSB obligations and additional payments have to be balanced against the benefits which arise from the holding of the licence including access to analogue spectrum. Historically, the costs to commercial companies of these obligations have been offset by the benefits arising from access to the spectrum. The net result is a broad equilibrium position as shown in Figure 1.

Figure 1



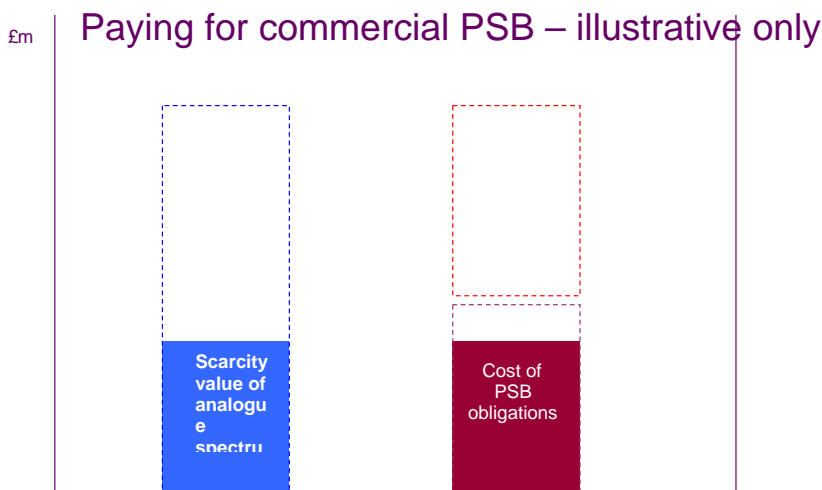
- 3.16 To date, the value of the analogue spectrum has been sufficient to justify the additional payments and the PSB obligations.
- 3.17 However, as digital penetration increases in the run up to digital switchover, the value of access to analogue spectrum decreases to commercial public service broadcasters. The revenue from advertising to viewers via the analogue platform therefore becomes a relatively less significant source of income. Furthermore, as an increasing number of homes have access to other, digital, platforms, the benefits that can be attributed to occupation of analogue spectrum decreases.
- 3.18 As a result, the amount a broadcaster would be willing to pay for the rights to analogue spectrum with the attached PSB obligations reduces. As illustrated in Figure 2, a relatively small decrease in the value of the analogue spectrum can result in a proportionately large reduction in the payments a broadcaster would be prepared to make.

Figure 2



3.19 This means that the decision on whether to continue holding the DRL or whether to pursue alternative routes to market becomes will inevitably become more marginal in future. This is particularly true at digital switchover and afterwards, when analogue viewing will fall to zero. Indeed, as illustrated in Figure 3, it is possible that at some point prior to switchover, the value of access to the analogue spectrum is offset in full by the cost to the licensee of meeting its PSB obligations. In such circumstances, a new entrant might be unwilling to pay more than a nominal sum for the licence.

Figure 3



3.20 These facts have been taken into account by Ofcom in determining the PQR rate and cash sum payable for the licences. Ofcom has taken into account the findings of the Public Service Broadcasting Review for each licence and the extent to which PSB requirements place a burden on the licence holder.

3.21 Ofcom has also made an assessment of how a potential bidder would incorporate expectations in relation to future PSB obligations into its valuation of the licence. The cost of PSB obligations is significant, and will remain significant even as the scarcity value of analogue spectrum decreases. If the PSB compact is to remain in place,

then the cost of additional payments must, by definition, fall to levels which allow licence holders to maintain their contribution to PSB output.

- 3.22 Ofcom considers that the financial terms announced today should provide a sustainable basis that allows licensees to meet all of their PSB obligations included in the licences, and that should maximise the potential contribution of PSB at and after digital switchover.

Advertising revenue

- 3.23 The level of future advertising revenue has been a significant input into Ofcom's estimate of the value of the licences. In December 2004, Ofcom published the findings of an economic analysis of the TV advertising market which it commissioned from PwC. The results updated and supplemented the work of Professor David Hendry on TV advertising elasticities carried out in 1992 and provided a key input into the advertising forecasts used by Ofcom in its determination of financial terms following this review. Among the key conclusions of this work were that the distribution of television advertising is changing from analogue channels to multi-channel channels as multi-channel increases its share of viewing.
- 3.24 Ofcom also took into account a number of other sources of information in order to form its view on future advertising trends. These included a range of external, market estimates for future advertising trends both from within the relevant industries and by independent forecasters and included recent, more cautious, estimates of near term advertising growth.

Digital penetration

- 3.25 The value of access to the analogue spectrum will depend on the growth in digital penetration between now and digital switchover. For the purpose of the valuation of the licences, Ofcom has considered the effects of a range of possible outcomes, informed by historical trends and market research into viewers' planned timetable for conversion of primary and secondary sets. Ofcom has assumed that digital switchover will be complete by 2012.

Individual licences

- 3.26 As noted previously, Ofcom valued each licence individually and did not take into account the current ownership structure and the extent to which this might impact upon the value of the licence.
- 3.27 Each licence has unique characteristics that have been taken into account in setting the new financial terms. The relevant characteristics of each licence include, but are not limited to, differences in the:
- geographic footprints
 - dayparts during which the licence gives access to analogue spectrum
 - regulatory obligations, including PSB obligations
 - expected date of digital switchover
 - bases for determining contribution to the network programme budget, if applicable

- 3.28 A wide range of factors have had to be taken into account in determining the value of each licence. Depending on the licence in question, these factors each have different implications upon the revenues that could be generated and the costs that would be incurred.
- 3.29 In turn, this impacts the estimate of what a new entrant might be prepared to bid in order to hold the licence. As already outlined, this estimate provides the basis for determining the cash bid of the incumbent and is, in broad terms, calculated by reference to the existing operator's cashflows, less an allowance for start up costs.
- 3.30 For example, the amount a new entrant would be likely to bid for a licence which might be expected to switch off the analogue signal in 2008 could be quite different from the amount a new entrant would be likely to pay for a licence which might be expected to retain the analogue signal until 2012. The extent of the difference would also depend on factors such as the type of audience available to the licence holder and the cost of the PSB obligations attached to the individual licence.
- 3.31 In the case of some licences, Ofcom considers that its analysis suggests there is a sound case for concluding that few, if any, bidders would be prepared to bid non-contingently for the individual licence and meet the required quality and financial sustainability thresholds that would be enforced over the life of the licence. This would be the case even given a low PQR rate for the purposes of making additional payments.
- 3.32 Ofcom has therefore determined that in such circumstances the regulator would set a PQR rate of 0% and the incumbent licence holder would be likely to retain the licence by posting a nominal bid, which Ofcom has set at £10,000. In these circumstances, nearly all of the obligations measured under the PSB compact are made up of PSB obligations, as opposed to a combination of PSB obligations and licence fee payments.
- 3.33 However, in the case of other licences which may, for example, have a later expected date for digital switchover, less onerous PSB obligations or a more valuable audience or a combination of these and other factors, Ofcom considers that there would be likely to be a competitive auction for those licences, even if they were offered on a non-contingent basis. In these circumstances, Ofcom has set licence payments, through a PQR rate and an estimate of the cash bid, which recover the value associated with the licence and where the cash bid represents Ofcom's estimate of what the incumbent licence holder would bid if the licence were being granted afresh.
- 3.34 The variety of outcomes for individual licences is reflected in Figure 4 below, which compares the PQR rate payable under existing financial terms with the PQR rate that Ofcom has now determined.
- 3.35 The rate set as a PQR varies significantly between different licences.
- 3.36 In some cases, the PQR set under the revised terms announced today is less than the PQR under the existing terms. In other cases, the PQR has risen. For each licence, the PQR rate set reflects, among other things:
- the value assigned to the licence;
 - the size of the revenue streams which the PQR is to be applied to;

- the extent to which future revenue streams are expected to be realised in a post-analogue environment; and
- the extent to which recovery of licence value is achieved through the PQR, rather than the cash bid.

3.37 As noted previously, Ofcom has attempted to recover 95% of the licence value through the PQR rate, where possible, subject to not more than 95% of the licence value being recovered through the PQR and subject to the PQR being set as an integer. This differs from the approach adopted by the ITC, which typically sought to recover 75% of the value of the licence from the PQR payment and the remainder from the cash sum. In some cases, this rebalancing of payments between the PQR and the cash sum is a significant factor in raising the PQR applicable for the licence under the new terms. In such instances, the cash sum under the revised terms is substantially lower than under the current terms. PQR rates under the revised terms can also rise as a result of the limited expected remaining life of certain analogue licences and the need to set terms to recover the licence value from revenues apportioned to the analogue service, which are in rapid decline due to future anticipated increases in the number of digital homes.

3.38 A higher PQR rate does not, then, imply that the quantum of licence payments is expected to increase. For each licence there are a number of different factors which, in Ofcom’s view, mean that the PQR set is appropriate within the context of the review. Under the PQR mechanism, actual payments by licensees will vary depending on future developments in advertising and sponsorship revenue and in digital penetration.

Figure 4

